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BREAKING THE RULES:

AT&T'S ATTEMPT TO BUY A NATIONAL MONOPOLY IN CABLE TV AND BROADBAND INTERNET SERVICES

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BREAKING THE RULES:
AT&T'S ATTEMPT TO BUY A NATIONAL MONOPOLY IN CABLE TV AND BROADBAND INTERNET SERVICES

EXECUTIVE SUMMARY

This paper analyzes the horizontal and vertical domination that AT&T is seeking to exert over the cable TV and broadband Internet markets through its acquisition of MediaOne and related deals with Microsoft and Cox.

- The proposed deal breaks every Federal rule designed to protect consumers from the abusive concentration of ownership in the 1990s.[1]

A. THE IMPACT OF THE MERGER AND RELATED DEALS

The AT&T-MediaOne merger and related deals have a pervasive impact across several markets (See Exhibit ES-1). The deals result in dramatic increases in concentration in horizontal markets including:

- cable distribution (to the extent that cable companies do or can compete in local, regional and national markets); cable programming (to the extent that programs compete to increase viewership); and broadband Internet services (to the extent that @Home and RoadRunner can and do compete).

The deals pose severe problems of vertical integration between programming and distribution.

- In cable, MediaOne/Time Warner are integrated with the previously acquired TCI distribution system.

- In broadband Internet services they integrate the @Home and RoadRunner programming services with a much larger distribution network and integrate distribution and equipment (the design and operation of the set top box by programming and distribution entities) by giving Microsoft preferred access.

The deals have elements of conglomeration of geographic and product markets.

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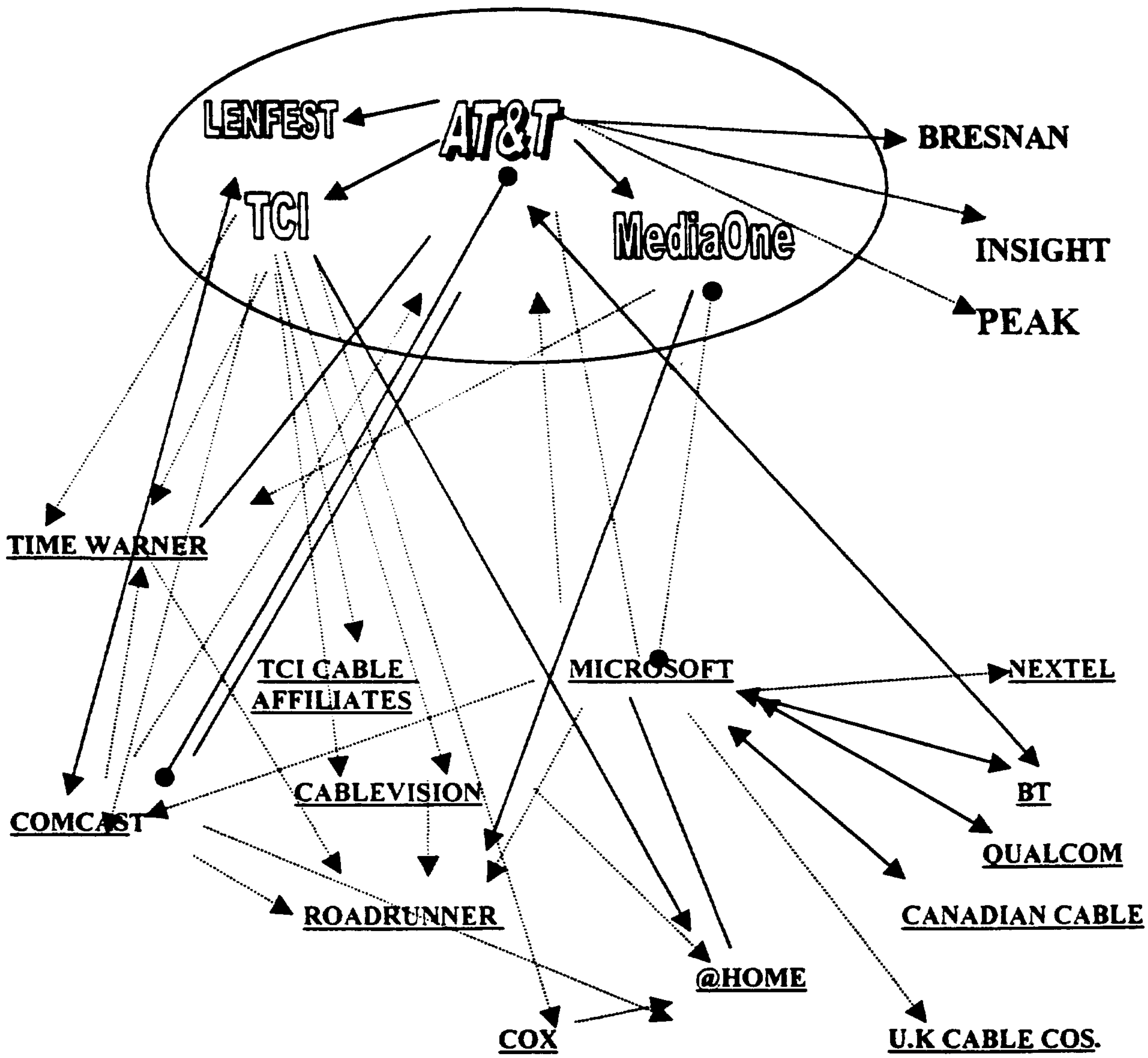
[1] These include the Horizontal ownership limits implemented by the Federal Communications Commission (FCC) under the 1992 Cable Act and the Merger Guidelines adopted by the Department of Justice (DOJ) under the Sherman and Clayton Acts.

EXHIBIT ES-1
AT&T' S DIGITAL CONGLOMERATE
AT THE HEART OF A BROADBAND CARTEL
(AS ANNOUNCED)



LEGEND:
STOCK OWNERSHIP: MAJORITY ⟶ ; MINORITY ⟶
JOINT VENTURE: ⟷
USE DEAL: EXCLUSIVE ——— ; PREFERRED ———
SWEETENERS: ●——●

- To the extent that distribution is considered a local market, the merger constitutes market-extension, since much greater geographic dominance is achieved.

- To the extent that the purpose of the merger is to utilize the broadband network to distribute cable, Internet and telephone service, it constitutes product-extension, with the power to dominate this new market.

B. BREAKING THE RULES ON CONCENTRATION OF OWNERSHIP

To summarize the horizontal concentration problem briefly, the Merger Guidelines state that the Department of Justice is likely to challenge mergers in moderately and highly concentrated markets that raise the level of concentrations (as measured by the Hirschman Herfindahl Index (HHI)) by 50 to 100 points. All of the markets that involve cable

EXHIBIT ES-2:
THE AT&T/MEDIAONE AND RELATED DEALS EXCEED THE LIMITS ON CONCENTRATION OF OWNERSHIP (AS FILED)

	LEGAL LIMIT	AT&T MEDIAONE IMPACT
FCC HORIZONTAL OWNERSHIP (% OF HOMES PASSED)		
CABLE	30	57
DOJ MERGER GUIDELINES (HHI INCREASE)		
CABLE		
DISTRIBUTION	50	1042
PROGRAMMING	50	1173
INTERNET		
CABLE-BASED BROADBAND		
DISTRIBUTION	50	2970
SERVICE	50	3596
CABLE-BASED BROADBAND +TELCO WIDEBAND		
DISTRIBUTION	100	700
SERVICE	50	2064

distribution, cable programming, broadband Internet distribution and broadband Internet programming would be moderately to highly concentrated as a result of the deals.

- The merger raises concentration in each of these markets by between 700 and 3,000 points.

Similarly, it fractures the FCC's limits on horizontal ownership.

- Under the FCC ownership attribution rules. AT&T would have about 55 million homes passed which would give it just over 57 percent of the Multichannel Video Programming Distribution market. Given that the FCC has adopted a limit of 30 percent, AT&T is well past the horizontal limit.

- AT&T will have just under 35 million subscribers. This would give it almost 50 percent of the cable TV market.

The horizontal concentration in these markets rises to a level that is unprecedented in the industry. This creates a unique and new barrier to entry to compete against AT&T's cable business, leaving consumers paying inflated prices even when there is some "choice" in the market.

- AT&T could use its vast footprint and leverage its market power to retaliate against an established cable. satellite or telephone company that sought entry into its region.

- As an excessively large programming purchaser. AT&T could exercise market power by raising prices or otherwise driving up costs.

The market concentration problem in the realm of broadband Internet service parallels the cable industry problem. The cable distribution plant is the dominant form of broadband Internet service. Even when developing telephone alternatives like Digital Subscriber Line (DSL) are accounted for, AT&T's broadband distribution system will dominate the market with the power to raise prices and costs to competitors.

The deals have a dramatic impact on programming concentration. The incentive and ability to frustrate competitive entry through leveraging of programming is quite clear.

- The cable companies involved in the AT&T deals are the dominant players by far. The merger raises the national concentration in cable programming by well over 1,000 points.

- The only two widely available Broadband Internet programming services – @Home and RoadRunner – are joined in the AT&T/MediaOne merger. The cable-based broadband Internet market is currently highly concentrated. The merger would increase the market share by 3000 points. If the analysis were done on actual customers, it would reveal an even more dramatic impact on the cable-based broadband Internet market.

Even if telephone wires and the current base of DSL customers are included, the merger fails to pass muster in the high speed Internet entertainment market.

- The market remains moderately concentrated in distribution and the merger increases concentration by much more than the Merger Guideline limit.
- In high speed Internet services the market remains highly concentrated and the merger adds over 2,000 points to the HHI.

C. THE ANTICOMPETITIVE EFFECTS OF EXTREME VERTICAL INTEGRATION

Although vertical mergers are less likely to be challenged as a general proposition, the AT&T-MediaOne merger and related deals present unique and troubling characteristics. Large dominant players in different markets are integrating through an acquisition strategy, not an expansion strategy.

- In addition to the direct ownership and control of vertically integrated activities, AT&T is using a variety of other means – contracts, leasing, etc. – to ensure vertical dominance.
- The size and market reach of the firm raises questions about barriers to entry caused by the need for others to simultaneously enter multiple market.
- The closed access policy being extended by AT&T from the cable TV industry to the broadband Internet industry creates problems of price squeeze and quality discrimination. The network is being designed technologically, implemented contractually and managed operationally in a way that discriminates against unaffiliated service providers and precludes certain forms of commerce.
- As part of the transaction, AT&T has entered into a series of exclusive and preferential deals for the use of facilities and products. Given the size of the parties and the nature of the market, this head start will provide an insurmountable advantage to dominant firms.

D. AT&T'S ATTEMPT TO HIDE THE PROBLEM

To obscure these critical problems in its application for license transfers at the Federal Communications Commission, AT&T establishes a series of diversions to deflect attention away from the fundamental market power issues raised by the merger and its related deals.

AT&T has proposed a series of minor spin-offs and restructured ownership. These do not get to the core of the market concentration or vertical integration problems.

AT&T claims to have voluntarily renounced its property rights by setting up Liberty Media as a tracking stock and Time Warner with a management committee. These "trust-me" firewalls are merely band-aids that do not solve the conflict of interest problem.

- There is no better proof that these gimmicks cannot be relied on than to recall that Liberty, the purportedly independent programming subsidiary within the holding company, has been spun off from TCI and pulled back so many times its corporate logo should be a yo-yo.

AT&T defines markets in overly broad terms. For example, AT&T argues that narrowband and broadband Internet services are in one market even though broadband is 100 times faster.

- This is like claiming that the pony express and Federal Express are comparable forms of mail delivery.

AT&T wants federal authorities to assume that future performance of competing technologies will prevent the abuse of market power, even though these very same technologies have failed to prevent the abuse of market power in the cable industry since it was largely deregulated in 1984.

- Wireless has never been able to discipline the pricing abuse of cable and its limitations for broadband Internet are even more severe.

- Digital Subscriber Line does not afford the speed of cable modems, is restricted in the number of households it can pass, is far behind in deployment and subscribers, and is likely to be a business-oriented, not a residential, service.

- AT&T has failed to compete using the very same technologies. Competitors now face the added problem of a massive, integrated company that must be overcome.

AT&T promises to finally deliver local telephone competition.

- As a general principle, trading massive increases in market power in one industry for a potential reduction in market power in another industry is bad public policy.

- As a practical matter, it is clear that the competition AT&T might bring to the local telephone market would not overcome the damage it would do to the cable TV and broadband Internet markets.

E. CONCLUSION

Consumers hope that technological breakthroughs will finally undermine the market power of the cable companies and prevent it from spreading to broadband Internet service, but merger and market power analysis cannot be based on hope or hype. Federal authorities must deal with the reality of markets.

- The AT&T deals are not a case of a close call that can be mitigated by small changes: this is a massive increase in concentration.

- The rules and guidelines that the merger violates are not "antiquated" relics of some past industrial age; all were adopted within the last decade by policymakers keenly aware of the structural rules necessary to promote competition.

AT&T is seeking exceptions from the rules in industries that are not immune to anticompetitive abuse.

- The primary industry in which the rules and guidelines are being violated – cable TV – was just last year called by the Department of Justice one of the nation's "most durable and powerful monopolies."

- The other industry in which the merger would have its anticompetitive impact (broadband Internet services) involves an industry and another company (Microsoft) that have already raised concerns at the Department of Justice.

Just two years ago the Federal Trade Commission (FTC) found that the relevant cable markets were concentrated, entry was difficult, and a previous merger involving Time Warner/Turner/TCI created the incentive and ability to lessen competition and increase prices to consumers. It rejected preferential deals for TCI (now owned by AT&T) and required reduction of TCI ownership in major interconnected firms to non-attributable, passive levels.

Federal authorities should be even more alarmed by the AT&T/MediaOne merger and related deals.

- The cable industry has become more highly concentrated and pricing abuses continue.

- The broadband Internet market is in an even more vulnerable condition.

- AT&T has added a thick layer of vertical domination atop horizontally concentrated markets.

- Given the web of cross ownership, joint ventures, and exclusive or preferential deals, the likelihood that any of the companies interconnected in the digital cartel will vigorously compete against the other companies in the cartel is slim.

I. PUBLIC POLICY CONCERNS ABOUT MARKET POWER IN THE CABLE TV AND BROADBAND INTERNET BUSINESS

This paper analyzes the horizontal and vertical domination that AT&T is seeking to exert over the cable TV and broadband Internet markets through its acquisition of MediaOne and related deals with Microsoft and Cox. The report is organized as follows.

Chapter I presents an introduction to the public policy issues involved and a brief overview of the findings and conclusions.

Chapter II presents a general framework for analysis and an overview of the many markets and market dimensions that are affected by the merger. It provides definitions and concepts and makes no direct reference to the specific merger. Those familiar with the industrial organization branch of economics or who cannot abide economic theory need not tarry here, as all of the empirical analysis is presented in chapters III and IV.

Chapter III presents a discussion of the horizontal concentration and vertical integration resulting.

A. COMMUNICATIONS ACT CONCERNS

1. CONCERNS ABOUT ECONOMIC CONCENTRATION IN THE CABLE TV INDUSTRY

Soon after AT&T announced its acquisition of MediaOne,[2] which itself came less than a year after the purchase of cable giant TCI, it discovered that federal rules on ownership of

[2] Graphic headlines give the context for the flap that the MediaOne acquisition set off (see, for example, Fahri, Paul, "AT&T: Too Big Once Again?," *Washington Post,* April 27, 1999, "AT&T Poised to Regain it Long Reach, Via Cable," *Washington Post,* May 6, 1999; Bank, David, "As World Collide, AT&T Grabs a Power Seat," *Wall Street Journal*, May 6, 1999, Quinton, Brian, "Stealing Home," *Telephony*, June 14, 1999 (hereafter, Stealing Home);

cable systems might pose a problem.[3] These rules, which were mandated by the 1992 Cable TV Act,[4] are intended to curb excessive market power in the ownership of cable distribution systems. The rules establish a framework for counting the number of subscribers a cable company owns/controls.[5] The rules attribute control of subscribers based on the ownership of a specific percentage of active (5% voting) and passive (10% non-voting) shares of stock.[6] They then establish an upper limit on the percentage of the national market that any one company can control.[7]

> FCC's suspended attribution rules define a mere 5% ownership of voting stock as sufficient for company to have "cognizable interest" under Sec. 613(f) of the Communications Act passed as part of 1992 Cable Act. For passive investments, only 10% interest is necessary. In adopting both these attribution rules and the 30% limit, FCC argued that limits were necessary to prevent any single MSO from having undue influence over programming access. Startup cable networks say they need access to at least 20 million homes to be viable, and fear that they could be blocked by MSO with cable control over too many homes. Owning 5% of MSO may entitle shareholder to seat on board, for example, providing substantial influence, Commission has said.[8]

---

[3] "AT&T Household Reach to be Issue in MediaOne Merger Review," *Communications Daily*, May 10, 1999 (hereafter, Household Reach).

[4] *Cable Television Consumer Protection Act of 1992,*

[5] *Notice of Proposed Rulemaking, In the Matter of Implementation of the Cable Television Consumer Protection Act of 1992 – Review of Commission Cable Attribution Rules*, 13 FCC Rcd. 12990 (1998).

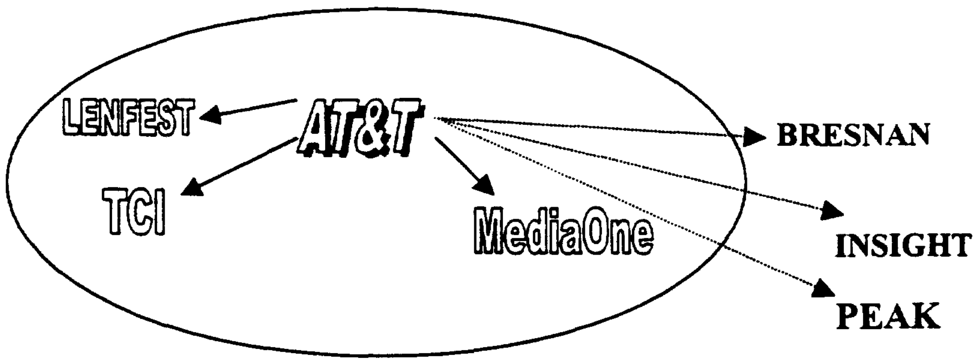
[6] Federal Communications Commission, *In The Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CC Docket No. 98-102, December 17, 1998, used these rules to describe the market structure of the cable and multichannel video program distribution (MVPD).

[7] *In the Matter of Implementation of Section 11(c) of Cable Television Consumer Protection and Competition Act of 1992 – Horizontal Ownership Limits, MM Docket NO. 92-264.*

[8] Household Reach, the style shortened style appears in the original publication .

Although the Federal Communications Commission (FCC) voluntarily stayed the rules, the FCC is in the process of vigorously defending them in court and is currently considering making minor modifications to them. In order to avoid running afoul of these rules, AT&T attempted to present itself as a large, but not too large, cable system owner. To present this picture, AT&T's ownership interest must take into account only large holdings in cables systems as depicted in Exhibit 1.

EXHIBIT 1
AT&T'S SELF-PROTRAIT AS A 'NOT TOO BIG' CABLE COMPANY



> AT&T chairman-CEO Michael Armstrong for 2 weeks has reassured financial analysts that merged AT&T-MediaOne Group wouldn't encounter significant regulatory hurdles. On May 5 he told analysts AT&T would pass only 35% of U.S. homes after deal "if the old [horizontal ownership] rules did come back, which we don't think they will.[9]

Under the FCC's rules, however, AT&T's market share is a concern. The ownership of cable interests that it portrays, as summarized in Exhibit 1 would give it between 23 and 35

[9] Household Reach.

percent of the cable TV market.[10] Even at this level. the merger could be challenged. However, with the attribution rules operative. AT&T is much larger and the merger would have a serious problem passing muster. Moreover. AT&T could be said to pass about 2/3 of homes through combination of those wholly owned systems and systems in which it would have a stake, such as Cablevision Systems (via former TCI) and Time Warner Entertainment (ex-MediaOne partnership).[11]

In an effort to convince Wall Street that regulatory approval of the merger would be easy, not only did AT&T paint a picture of a somewhat large. but not too large cable company, it assured investors that it had been talking to the FCC about the issue.

> As for suggestions that AT&T has told investors it's talking with Commission when in fact it is not. Cicconi said "we absolutely have had conversations with a number of people over there [at FCC], including today.[12]

AT&T's general counsel also launched an attack on the federal rules that limit the market share any single cable company could own.

> When confronted with this analysis however, AT&T General Counsel James Cicconi said: "These inflated figures... are absurd on [their] face."
>
> Cicconi in conference call Fri. faulted "absurd" attribution rules from FCC... Told that FCC Cable Bureau might find AT&T passed 2/3 of homes under attribution rules, he said, "that's absolutely not the right figure. Cicconi said AT&T doesn't feel Cablevision and Time Warner ownership should count.[13]

---

[10] "A Win-Win for Comcast, AT&T," *Broadband,* May 6. 1999 (hereafter Win-Win), attributes to AT&T Chairman Michael Armstrong and estimate "of 23% – 35% (depending on how the FCC ultimately defines cable ownership) of the nationwide cable homes passed,"

[11] Household Reach.

[12] Household Reach.

[13] Household Reach.

AT&T's problem, however, was bigger than a near miss on the horizontal ownership limits. After testing the waters in Washington, AT&T found that there are some policymakers who not only take the horizontal ownership limitations seriously, but also consider vertical integration of programming and control over broadband Internet access using cable modems to be important public policy issues.[14] Policymakers,[15] competitors,[16] and public interest groups[17] expressed concerns and congressional hearings were held.[18]

If AT&T could not simply steam roll through the regulatory review process, the entire corporate structure that it had constructed as part of its foray into the cable industry would be closely scrutinized.[19] The actual structure of vertical and horizontal ownership and control that AT&T had amassed was quite different than the simple, self-effacing self-portrait AT&T was painting.

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[14] Cleland, Scott C. and Patrick Brogan, "The Regulatory Landscape on Cable Equal Access," *Legg Mason Precursor Research*, May 18, 1999; "Not So Fast, AT&T: DC Reminds Dealmakers of Its Relevance in Setting Approvals," *Phillips Publishing International*, May 11, 1999; Borland, John, "Broadband Cable Access Issue Reaching Congress," *CNET News. Com*, July 6, 1999.

[15] The TCI merger had already stimulated concerns, see for example, the hearing before the Communications Subcommittee, Senate Committee on Commerce, Science and Transportation, April 13, 1999; Schiesel, Seth, "Concerns Raised as AT&T Pursues New Foothold," *New York Times*, May 6, 1999; McConnell, Bill, "Washington to Scrutinize Merger," *Broadcasting & Cable*, May 10, 1999.

[16] Seminerio, Maria, "Group Demands Open Access to Cable Lines," *ZDNet: PCWeek OnLine*, February 4, 1999.

[17] *Letter to Chairman Bill Kennard from Center for Media Education, Computer Professionals for Social Responsibility, Consumer Federation of America, Consumers Union, Media Access Project*, January 27, 1999, requesting an expedited hearing on open access.

[18] "AOL, Cable Execs, Sprint Square Off over Broadband Access," *CNNfn*, June 24, 1999.

[19] "FCC to Scrutinize AT&T, MediaOne Deal," *Broadband*, May 10, 1999.

Exhibit 2 depicts the various ownership, joint-venture, and leasing arrangements that constitute what can rightly be called a digital, communications cartel. Not only do the number of cable subscribers that are attributable to AT&T skyrocket once the attribution rules are invoked, but AT&T's ownership of programming and Internet services, as well as its equipment deals come into view. Once the concentration of excessive economic power behind this merger is recognized and questioned, AT&T faces a problem.

Recognizing that the scrutiny would be far more probing than it had hoped, AT&T began to restructure its presence in the cable TV industry with respect to some of its more prominent holdings.[20] By all accounts, it still intends to keep its Cablevision and Time Warner interests, as well as its broadband Internet ventures. AT&T appears to be trying to come close enough to horizontal guidelines to get a waiver, if it could not come into actual full compliance with the rules.[21] These actions might alleviate the pressure on the vertical aspects of the merger and related deals and make a waiver more likely.

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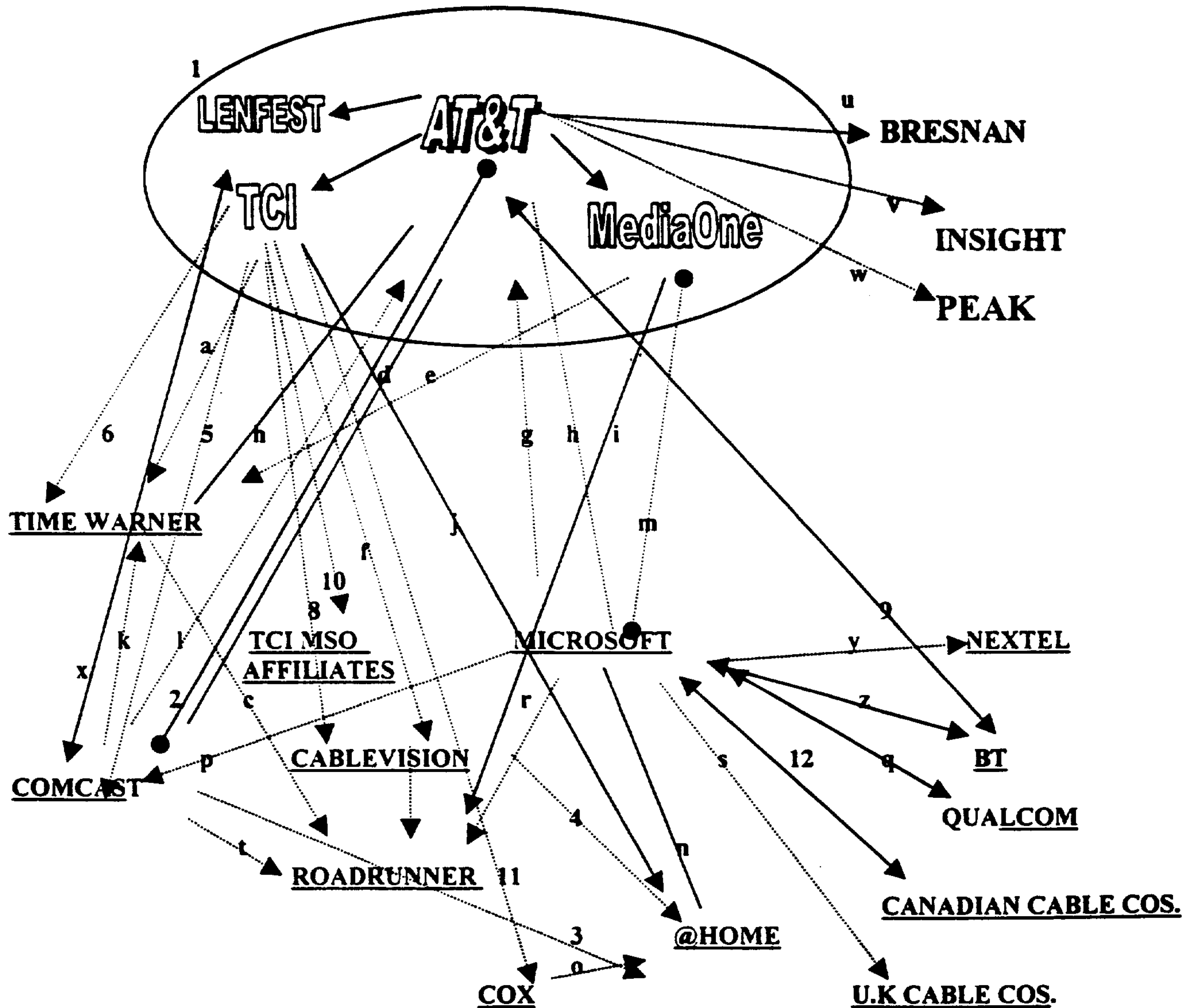
[20] Higgins, John, M., "AT&T's Incredible Shrinking Plan," *Broadcasting & Cable*, May 31, 1999; Cho, John, "AT&T Seeks to Dissolve Most JV Thru Swaps," *Cable World*, June 28, 1999.

[21] Win-Win, presents the following discussion, including Armstrong's suggestion that the cap should be raised

> Although the FCC rules, currently suspended pending an upcoming rewrite, cap cable system ownership at 30% of all national homes passed, some cable lawyers think it is likely the new rules will raise the cap to 35%, potentially allowing AT&T to squeak under that limit with the Comcast adjustments.
>
> Even if AT&T slips above the cap, the company will comport itself to fit the regulatory rules, Armstrong said. Still Armstrong made his case on why the rules need to be changed. First, "with the whole world going digital and the need to compete with local telcos," he argued, the cap should be raised. The homes passed component, he argued, should be changed to take into account the multiple competitors, such as direct broadcast satellite and streaming Internet video, that now reach any given home.

EXHIBIT 2
AT&T' S DIGITAL CONGLOMERATE
AT THE HEART OF A BROADBAND CARTEL



LEGEND:
STOCK OWNERSHIP: MAJORITY ; MINORITY
JOINT VENTURE:
USE DEAL: EXCLUSIVE ; PREFERRED
SWEETENERS:

DESCRIPTIONS OF RELATIONSHIPS AND IDENTIFICATION OF SOURCES:

1 = wholly owned subsidiaries (2)
2 = $1.5 billion breakup fee (10)
3 = large minority (12); 12% (16)
4 = (6)
5= QVC Joint venture (16)
6 = Programming joint venture through Liberty (22); 10% (16)
7 = Wholly owned (16)
8 = Programming joint venture through Liberty (22); Investment (19)
9 = (20)
10 = TCI MSO Joint ventures (4)
11 = Programming joint venture through Liberty (22)
12 = Set top box joint venture (15)

a = 10% Ownership of Time Warner (23)
b = exclusive deal for telephony (6)
c =25% (6)
d = exclusive deal for telephony (5)
e = 26% (1)
f = 25% (1) (4)
g = 3% ownership (3) (5)
h = up to ten million set tops guaranteed (3)
i = Majority (5); 25% (6)
j = 39% (6)
k = 25% (6)
l = exchange of systems is likely to be consummated with a stock swap (2)
m = Microsoft gets to buy MediaOne's European cable systems (9)
n = Windows NT in @Home solutions network (13)
o= Minority (6)
p = 11% ownership (5) (12)(17)
q = wireless Internet (8)
r = Through Comcast (5)(12); Direct (18); 10% (16) (20)
s = 5% NTL, 30% Telewest, 30% Cable&wireless (14)
t = Minority (5)(12)
u = 49% (1)
v = 34% via MediaOne (1)
w = Majority (1)
x = Manager of AT&T owned systems (7) (11)
y = 4% (8)
z = wireless Internet (8)

SOURCES:

(1) "AT&T Household Reach to be Issue in MediaOne Merger Review," Communications Daily, May 10. 1999.

(2) "War Ends: AT&T and Comcast Cozy up in Solomon-Like Deal," Broadband Daily, May 5, 1999.

(3) "AT&T Comes Out on Top in Microsoft Deal," Broadband Daily, May 10, 1999.

(4) "FCC to Scrutinize AT&T MediaOne Deal." Broadband Daily, May 10, 1999.

(5) "AT&T Poised to Regain Long Reach, Via Cable," Washington Post, May 5, 1999.

(6) "AT&T Goes Cable Crazy," Fortune, May 24, 1999.

(7) AT&T Chief's $120 Billion Plan Capped by Deal for MediaOne," Washington Post, May 6, 1999.

(8) "Microsoft to Buy A Stake in Nextel," Washington Post, May 11, 1999

(9) Allan Sloan. "AT&T-MediaOne Soap Opera Has Just About Everything," Washington Post, May 11, 1999.

(10) "Pact Ends MediaOne Bid War." Washington Post, May 6, 1999.

(11) "Comcast, in AT&T Accord, Abandons MediaOne Bid," Wall Street Journal, May 6, 1999.

(12) "As Worlds Collide, AT&T Grabs Power Seat," Wall Street Journal, May 6, 1999.

(13) "Microsoft, @Home Make Broadband Pact," ZDNet, May 13, 1999.

(14) "A Contest Is On In Britain to Revolutionize Cable TV," New York Times, May 13, 1999.

(15) "Rogers Communications and Microsoft Announce Agreements to Develop and Deploy Advanced Broadband Television Services in Canada." *Microsoft Presspass,* July 12, 1999.

(16) Schiesel, Seth, "Concerns Raised as AT&T Pursues a New Foothold, New York Times, May 6. 1999.

(17) Fabrikant, Geraldine and Seth Schiesel, "AT&T Is Seen Forging Link to Microsoft," New York Times, May 6, 1999.

(18) Markoff, John, "Microsoft Hunts Its Whale, the Digital Set-Top Box," New York Times, May 10. 19999.

(19) "ACTV Gets Boost from Liberty Digital," Broadband Daily, May 17, 1999.

(20) Wolk, Martin, "Microsoft Poised for major Role in New Industry," Reuters, May 6, 1999.

(21) Fabrikant, Geraldine and Laura M Holson, "Key to Deal for MediaOne: Keeping the Losing Bidder Happy," New York Times, May 6, 1999.

(22) Federal Communications Commission, In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, CC Docket No. 98-102, Fifth Report, Table D-6.

(23) Federal Communications Commission, In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, CC Docket No. 98-102, Fifth Report, Table D-1.

B. CONCERNS ABOUT BROADBAND INTERNET ACCESS

AT&T's problems at the federal level are not its only difficulties. Within months of the announcement of the MediaOne deal. AT&T lost a ruling related to its prior acquisition of TCI.[22] A Federal District Court judge had ruled that the City of Portland, as the franchising authority for cable services, had the right to order the former TCI franchise, now owned by AT&T, to provide nondiscriminatory access to broadband Internet services.

The initial experience in Washington did not change AT&T's attitude about its duty to comply with this country's laws. AT&T insists that its legal right to sign an exclusive contract with an Internet service provider takes precedence over the right of the franchising authority to impose an open access requirement. It has threatened not to deploy the service.

> AT&T says the ruling is a catch-22 because the company's contract with @Home grants @Home exclusive distribution rights on AT&T's cable network.
>
> "They have put in place an ordinance we cannot comply with legally or technically," says John Cicconi, AT&T's general counsel. "It is not a condition with which we can comply and still deploy the @Home offer. The real losers in this decision, until it is overturned, are the people of Portland."
>
> In response to AT&T's vow to withhold @Home, Portland officials are considering opening the city's nonexclusive franchise to a second operator.[23]

AT&T again attacked the intelligence of the ruling.

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[22] *AT&T; Tele-Communications, Inc.; TCI Cablevision of Oregon, Inc., and TCI of Southern Washington v. City of Portland and Multnomah County,* In the United States District Court for the District of Oregon, CV 99-65-PA, June 3, 1999

[23] Colman, Price and Bill McConnell, "AT&T's Got the Unbundling Blues," *Broadcasting & Cable*, June 14, 1999 (hereafter, Unbundling Blues).

> Cicconi is confident AT&T will win on appeal, though he acknowledges Panner's ruling was a surprise. "Did we expect this? No," he says. "In a case you don't even consider to be close on the law, you don't expect the court to reach such a result."[24]

Similar disputes relating to the transfer of TCI licenses bubbled up in cities across the country.[25] Broward County, Florida voted for open access.[26] A technology commission in Los Angeles experienced the resignation of three of its members (thereby losing its quorum) in protest over a report that argued against imposing open access on cable broadband Internet services.[27] Similar disputes arose in San Francisco, where the City Council rejected a staff report that failed to recommend open access[28] and later voted to declare a general commitment to open access and to join in the Portland suit, but did not adopt specific open access requirements.[29] Counties weighed in on the side of open access.[30] Washington

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[24] Unbundling Blues.

[25] Quinton, Brian, "Cities Prep for AT&T Siege," *Telephony*, June 28, 1999

[26] Chen, Kathy, "Another Local Government Votes to Open Cable Lines to Competition," *Wall Street Journal*, July 14, 1999.

[27] Guy, Sandra, "Cities March Noisily Into Internet Access Battle," *Techseb*, June 22, 1999; Mullen, Alex, "Broadband Access Battle Erupts," *ZDTV*, July 8, 1999; Grice, Corey, "Cities Take Open Access Fight to the FCC," *CNET News*, June 21, 1999.

[28] Solomon, Deborah, "S.F. Board President Opposes AT&T Cable Plan," *San Francisco Chronicle*, June 24, 1999.

[29] Healy, Jon, "AT&T Wins S.F. Vote on Access," *Mercury News*, July 28, 1999.

[30] Seminerio, Maria, "counties Call for Open Access," *ZDNet*, July 20, 1999.

policymakers were not inactive in the broadband issue. with hearings[31] and legislation introduced on all sides of the issue.[32]

AT&T's acquisition of MediaOne's broadband services also raises another set of concerns because it includes a deal with Microsoft to supply a very large part of the initial orders for set-top boxes to deliver broadband services. As part of the final deal Microsoft will be allowed to deploy between 7.5 and 10 million of the first set-top boxes.[33]

Microsoft is currently embroiled in the most celebrated antitrust case in several decades (since the breakup of AT&T). The case alleges that Microsoft had engaged in a variety of anticompetitive practices to defend its monopoly control over the operating system for PCs and extend it to web browsers. Microsoft's deal with AT&T gives it the inside track in providing the operating system for broadband set-top boxes. This agreement immediately drew analogies between the interactive broadband market and the PC market.

> The laggards feared that they would inevitably fall victim to the same forces that enabled Microsoft to reduce many PC hardware makers to mere purveyors of commodity goods.
>
> But Microsoft's considerable financial heft has eroded most resistance. Besides the Comcast stake, Mr. Gates' investments in pursuit of interactive digital TV have included WebTV, Time Warner's Road Runner, four European interactive cable television investments and, finally, last week's investment in AT&T.

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[31] Woods, Bob, "AOL, Cable Execs, Sprint, Square Off Over Broadband Access," *CNNfn*, June 24, 1999; Cable Honchos Fumble Senate Appearance," *The Industry Standards*, July 15, 1999.

[32] Rick Boucher, "Internet Growth and Development Act of 1999; Bob Goodlatte, Internet Freedom Act; Billy Tauzin and John Dingell, "The Internet Freedom and Broadband Deployment Act of 1999; Ed Markey, "Concurrent Resolution;" Earl Blumenauer, "Consumer and Community Choice Access Act.

[33] Austria, Melanie, "Microsoft, AT&T in $5 Billion Pact," *CENT News.Com*, May 6, 1999.

In return for a $5 billion stake, AT&T has warily agreed to license a minimum of five million copies of Microsoft's Windows CE operating system and engage in several showcase tryouts of the software, the consumer electronics version of Microsoft's industry-dominating Windows software for PCs.

The deal will ensure that Microsoft gets an inside track in the new interactive television industry, which after years of delay appears to be showing signs of life. [34]

Although the deal was preferential, not exclusive,[35] the union of two giant firms with a history of market domination could not go unnoticed. In fact, after securing preferential access to as many as 10 million of AT&T broadband cable subscribers, Microsoft inked another deal with @Home, a subsidiary of AT&T, to extend its reach even further by capturing part of the server side of the market.[36] It quickly signed similar deals with other cable companies to provide software and acquired interests in other cable companies, increasing its early advantage.[37]

C. ANTITRUST PROBLEMS

1. HORIZONTAL CONCENTRATION

Although the public policy debates with FCC regulators and local officials have received the greatest attention, the AT&T-MediaOne merger also has problems over at the Department of

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[34] Markoff, John, "Microsoft Hunts Its Whale, the Digital Set-Top Box," *New York Times*, May 10, 1999.

[35] "AT&T Comes Out on Top in Microsoft Deal," *Broadband*, May 7, 1999.

[36] Broersma, Matthew, "Microsoft, @Home Make Broadband Pact," *ZDNET*, May 13, 1999;

[37] Bank, David, "Microsoft to Invest $600 Million in Nextel," *Wall Street Journal*, May 11, 1999; Cowell, Alan, "A Contest is On In Britain to Revolutionize Cable TV," *New York Times*, May 13, 1999; Broadband Daily, *Microsoft's Broadband Investments Total $11 Billion*, June 11, 1999; Bruznick, Alan, "Microsoft Sinks $30 Million into Wink," *Cable World*, June 14, 1999;

Justice. Merger Guidelines issued in 1992 established standards under which mergers are likely to be challenged[38] These guidelines, originally written early in the Reagan administration, establish what are, by historical standards, fairly lenient standards for mergers. Yet, as shown in Exhibit 3, in every media market affected by the merger, the Guidelines are violated by a wide margin.

To summarize the problem briefly, the Merger Guidelines state that the Department of Justice is likely to challenge mergers in moderately and highly concentrated markets that raise the level of concentrations (as measured by the Hirschman Herfindahl Index (HHI)) by 50 to 100 points. All of the markets involved – cable distribution, cable programming, broadband Internet distribution and broadband Internet programming – are moderate to highly concentrated. The merger raises concentration in every one of these markets by between 1,000 and 3,000 points. In simple terms, this is not even a close call and in several markets the merger increases concentration dramatically.

2. VERTICAL CONCERNS

Although vertical mergers are less likely to be challenged as a general proposition, the AT&T-MediaOne merger and related deals presents unique and troubling characteristics. Large dominant players in related markets are merging. An acquisition strategy, not an expansion strategy, has been used to create a huge entity in a dominant position across several markets. In addition to the direct ownership and control of vertically integrated

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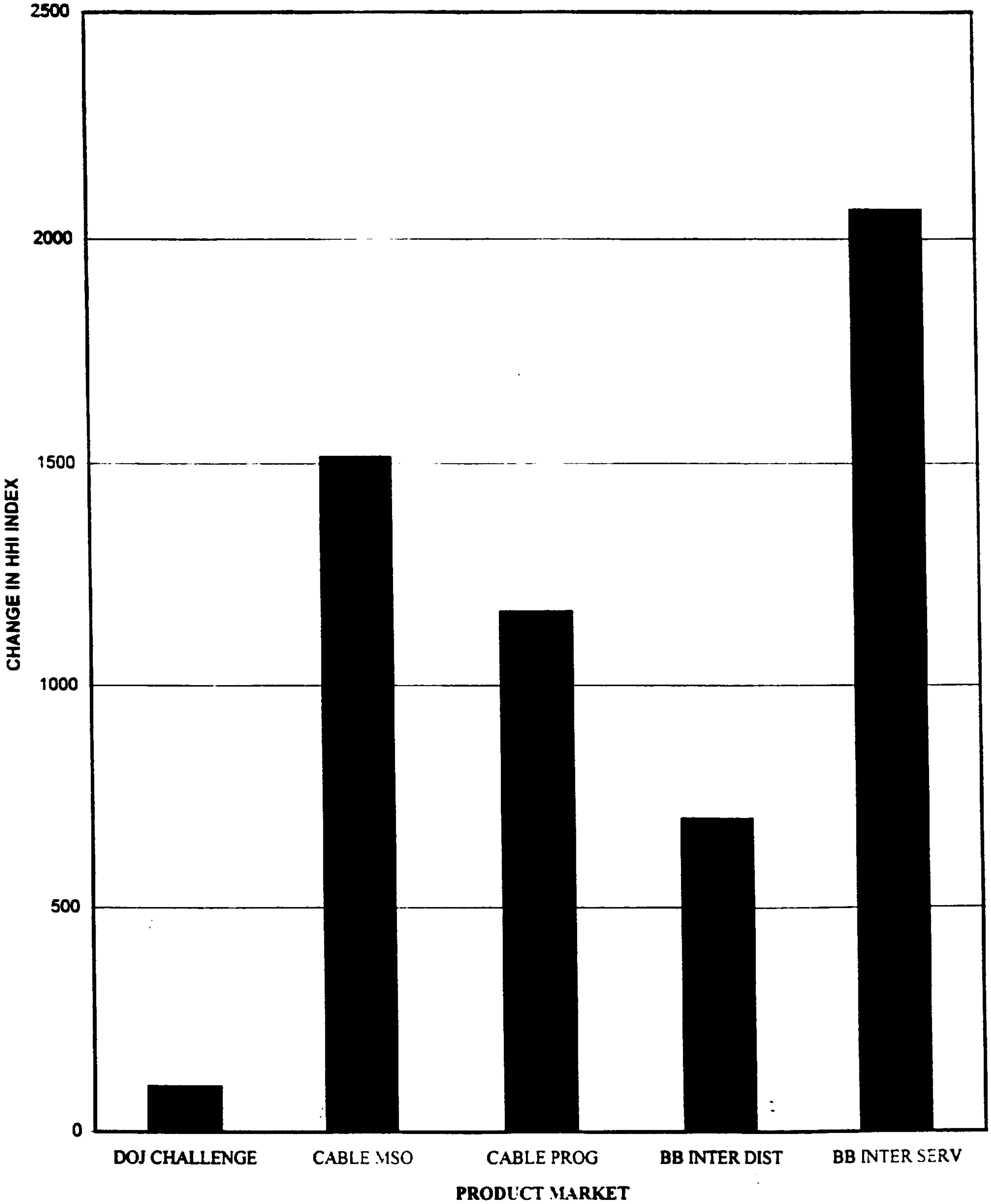
[38] Department of Justice and Federal Communications Commission, *Merger Guidelines*, 1992.

EXHIBIT 3:
HHI CHANGES IN MARKET CONCENTRATION
RESULTING FROM THE AT&T/MEDIAONE MERGER
COMPARED TO DOJ GUIDELINES



activities. AT&T is using a variety of other means – contracts, leasing, etc. – to ensure vertical control.

The size and market reach of the firm raises questions about barriers to entry caused by the need for others to simultaneously enter multiple market. The closed access policy being defended by AT&T reinforces the need to enter multiple markets.

The closed access policy creates problems of price squeeze and quality discrimination. The network is being designed technologically, implemented contractually and managed operationally in a way that discriminates against unaffiliated service providers and precludes certain forms of commerce.

3. THE MERGER'S PERVASIVE STRUCTURAL IMPACT

The AT&T-MediaOne merger has a pervasive impact across several markets and involves four different aspects of market structure:

> A **horizontal** merger is a marriage of rivals. It involves firms doing "the same" thing in "the same" market...
>
> A **vertical** merger involv[es] companies in a supplier-customer relationship...
>
> **Conglomerate** mergers...: [are] **market-extension,** mergers, in which the acquiring and acquired firms do the same thing in different geographic markets; **product-extension** mergers, in which the products (or activities) of the partners do not compete with each other but have some functional relationship in production or distribution.[39]

[39] Asch, Peter, *Industrial Organization and Antitrust Policy* (John Wiley and Sons, New York: 1983), pp. 262-263.

The AT&T proposal to purchase MediaOne and the subsequent deals that have been struck with Comcast and Microsoft[40] result not only in a huge financial transaction but one that contains elements of every type of merger. The deal has elements of horizontal merger in cable distribution and horizontal merger in cable programming. It has elements of vertical integration between programming and distribution. It has elements of conglomeration of geographic and product markets.

As described in Exhibit 4, the horizontal aspects of the merger involve mergers between cable distribution systems (to the extent that they do or can compete in regional and national markets). It involves concentration of cable programming (to the extent that programs compete to gain access to customers). It involves concentration of Internet programming (to the extent that @Home and RoadRunner sell the same thing to the public).

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[40] There is some sense in which the side deals may have been necessary to preserve cooperative relations among the various companies, a source of concern itself. A *New York Times* ("Key to Deal for MediaOne: Keeping the Losing Bidder Happy," May 6, 1999, story describes the side deals as follows:

> Comcast had sought help from Microsoft the previous week, hoping that the software giant would dig into its $22 billion cash coffer to aid the company in its bid. But even as Microsoft's chief financial officer, Gregory Maffei, met that week with Comcast at the offices of Sullivan & Cromwell, Microsoft's law firm, the Comcast team knew that Microsoft representatives were simultaneously meeting with its rival, AT&T, indicating that Microsoft might only be using the talks with Comcast as leverage in the AT&T negotiations...
> But AT&T executives also knew it was wiser to strike a friendly deal with the cable operator with which it hoped to do business in the future...
>
> Why was AT&T eager to be the industry goliath, willing to give up control of more than four million subscribers? Company executives did not talk publicly, but one person involved in the talks noted that it would behoove AT&T -- which is trying to offer local telephone service through alliances with cable companies -- not to alienate Comcast. "Having Comcast, which control six million homes, or 10 percent of the cable industry, as an avowed enemy for life was not smart," said the participant on the condition of anonymity.

EXHIBIT 4
MARKET STRUCTURE ASPECTS OF THE AT&T-MEDIAONE MERGER AND RELATED DEALS

MERGER IMPACT	CABLE	BROADBAND INTERNET
HORIZONAL CONCENTTRATION	DISTRIBUTION TCI/MediaOne, Comcast deal	DISTRIBUTION TCI/MediaOne,
	PROGRAMMING TCI/TWE/MediaOne	PROGRAMMING @Home/Road Runner
VERTICAL INTEGRATION	PROGRAMMING/ DISTRIBUTION TCI/TWE/MediaOne	PROGRAMMING/ DISTRIBUTION @Home/Road Runner- TCI/TWE/MediaOne
		DISTRIBUTION/EXHIBITION AT&T/Microsoft
MARKET EXTENSION	CABLE COVERAGE	INTERNET COVERAGE
PRODUCT EXTENSION	CABLE/BROADBAND CONVERGENCE	

The vertical aspects of the merger involve the integration of programming and distribution. In cable, MediaOne's programming and distribution will be integrated with the previously acquired TCI programming and distribution. In broadband Internet services the merger integrates programming and distribution services to the extent that @Home and RoadRunner are not currently integrated with a much larger distribution network. It involves the integration of distribution and equipment (the design and operation of the set top box by programming and distribution entities), through the deal with Microsoft.

To the extent that distribution is considered a local market, the merger constitutes market-extension, since much greater coverage is achieved. To the extent that the purpose of the merger is to utilize the broadband network to distribute cable, Internet and telephone service, it constitutes product-extension.

Economic and antitrust policy has generally been most adverse to horizontal mergers and least adverse to conglomerates, but it can, under certain circumstances, find fault with a merger that involves any one of the above areas. Needless to say, a merger that involves all four should be subject to extremely close scrutiny.

4. MARKET POWER GAINED BY MERGER, NOT EXPANSION

Second, we note that the issue here is not simply size or vertical integration, as such, but size and vertical integration through merger. If AT&T had increased its size or effectuated this integration through expansion into new areas, there would be no debate about its action. The merger literature places considerable importance on the decision to attack markets through merger, rather than expansion.

> [V]ertical merger may have an adverse competitive impact by eliminating specific potential entrants who could integrate by vertical expansion rather than merger.[41]

In this case, the fact that AT&T has chosen the merger route takes on even greater significance because it contemplated other routes. It was a self-declared competitor whose decision to buy rather than fight is especially troubling. AT&T announced at least two other

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[41] Perry, Martin K., "Vertical Integration: Determinants and Effects," in Richard Schmalensee and Robert D. Willig (Eds), *Handbook of Industrial Organization* (North Holland, Amsterdam: 1989), p. 247.

decisions to follow a market expansion path to increasing its size and scope of activities, but it abandoned these approaches.[42] It now claims that other companies can and should take the expansion route, which it rejected. It is ironic that AT&T now claims that its effort to achieve vertical integration through merger should be allowed because other firms can accomplish the same thing through expansion that it could not. If AT&T could not expand into these fields when they were not dominated by one huge, vertically integrated firm, it is hard to see how smaller rivals can overcome a larger obstacle.

D. BREAKING THE RULES BY DIVERTING ATTENTION FROM MARKET POWER

Before we begin the detailed analysis of concentration, it is important to point out what this paper does not consider. It does not analyze competition in the local telephone market. It does not contemplate changing the guidelines on ownership limitations. It does not consider changing the rules on attribution of ownership and control of corporations. It does not consider these things and policymakers should not.

If regulators go down that path, each merger will ask for a special exception from the general principles of consumer protection and there will be nothing left. Public policy to protect consumers from the abuse of market power will be completely undermined if regulators allow specific deals to rewrite the rules. This merger breaks all the rules, as they stood before it was proposed, and it should be stopped.

[42] Ironically, one of the technologies AT&T abandoned – wireless loop – is one it claims will be a competitor.

The merger violates rules and guidelines by a wide margin. This is not a case of a close call that can be mitigated by small changes. The rules and guidelines that the merger violates are not "antiquated" relics of some past industrial age. All were adopted less than a decade ago. Nor is AT&T seeking exceptions from the rules in industries that are immune from anticompetitive abuse. The primary industry in which the rules and guidelines are being violated – cable TV – was just last year called by the Department of Justice one of the nation's "most durable and powerful monopolies." [43] The other industry in which the merger would have its anticompetitive impact (broadband Internet services) involves an industry and another company (Microsoft) that have already raised concerns at the Department of Justice.[44]

How could one of America's must trusted corporations disregard such clear evidence that the merger breaks the rules and expect to sail the merger through without encountering significant regulatory hurdles? The answer is that AT&T establishes a series of diversions to deflect attention away from the fundamental issues raised by the merger and its related deals.

1. LOCAL TELEPHONE COMPETITION

The first diversion is to concentrate on local telephone competition. By concentrating on its promise to provide facilities-based competition for local telephone services, AT&T is attempting to divert attention from its dominance in other markets. Policy makers are backed into a corner by AT&T's claim that the only way to get local telephone competition is to

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[43] Wilke, John R., "antitrust Suit Filed to block Primestar Purrchase," *Wall Street Journal*, May 13, 1998.

[44] A consumer view of the case is provided in *The Consumer Case Against the Microsoft Monopoly* (Consumer Federation of America, Media Access Project and U.S. PIRG: October 1999).

allow the creation of a near national monopoly over cable TV wires (which also creates a clear monopoly over broad-band Internet services). Policymakers should reject this diversion for several reasons.

First, as a general principle, they should not trade massive increases in market power in one industry for a potential reduction in market power in another industry.[45]

Second, with respect to the specific market, it is doubtful whether the competition that AT&T would actually bring to the local market would be worth the damage it would do to the cable TV and broadband Internet markets. This is the fifth local entry strategy that AT&T has declared since the passage of the Telecommunications Act.[46] In spite of the fact that AT&T is the largest telecommunications company in the country and has a history of providing local telephone service, it has proven to be far from an effective local service competitor.[47] There is no reason to believe it will do any better with this strategy than it has with its others.

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[45] Consumer organization have been among the most vigorous critics of Regional Bell Operating Company failure to open local markets and their grossly inflated claims to consumer savings from premature entry into the long distance market (see Consumer Federation of America, *Stonewalling Local Competition: The Baby Sell Strategy to Subvert the Telecommunications Act of 1996* (January 1998), *Affidavit of Mark N. Cooper on Behalf of the Consumer Federation of America*, before the Public Utility Commission of California R.93-04003, I.93-04-002, R.95-04043, R.85-04044, June 1998; *The Consumer Stake in Vigorous Competition in the Illinois Local Telephone Market*, March 1999). We apply this same principle within the telecommunications industry. One of the fundamental principles we have advocated in opposing premature entry by the RBOCs into long distance is that even if there are small gains to made with long distance entry, they should not be achieved at the expense of lost gains from local competition.

[46] The five are resale, wireless loop, unbundled network elements, IP telephony over cable wires and circuit switched telephony over cable TV wires.

[47] For example, in August 1999, AT&T announced 6,000 residential subscribers in New York, the most open local market in the nation. In contrast, MCI claimed over 20 times as many residential subscribers.

Third, the economics of local telephone competition also make it highly unlikely that telephone competition is what this merger is about.[48] The money to pay for this merger comes from the exercise of market power in the cable TV and broadband Internet businesses, not competition for local telephone business.[49] AT&T's cost structure makes it virtually impossible to deliver significant price competition in local telephone service.[50]

2. TRUST-ME SECURITIES

AT&T's second diversion lies in efforts to redefine ownership limits. AT&T wants authorities to water down or abandon their definitions of influence over companies through ownership or through control of customers. Where the ownership share is small AT&T wants the FCC to ignore it. Where it is large, AT&T wants the FCC to accept voluntary safeguards as a check on concentration of ownership.

AT&T argues that it programming subsidiaries have complete independence. Liberty Media is a tracking stock. Time Warner has a management committee. In essence, AT&T claims to have voluntarily renounced its property rights in and ability to influence its own

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[48] AT&T's acquisition costs per subscriber of $4000 to $4500 are four times the FCC's most recent estimate of the economic costs of building an efficient telephone network (see Federal Communications Commission, *Synthesis Proxy Cost Model Results*, Version 2.6).

[49] Estimates of revenues to support deployment of two-way cable networks list telephone revenues as the smallest contributor (see Morgan Stanley Dean Whitter, *The Digital Decade*, U.S. and the America Investment Research, April 6, 1999, p. 11; Higgins, John M, "All For Just $5,000," *Broadcast and Cable*, May 10, 1999).

[50] In the course of refuting RBOC claims on efficiency CFA has estimated potential long-term efficiency gains in local telephony on the order of approximately $10 billion per year. This estimate assumes a cost structure similar to that embodied in the FCC's Synthesis Proxy Cost Model. AT&T's acquisition cost of MediaOne and its combined acquisition/upgrade cost of TCI indicate it could not place the downward pressure on local prices necessary to achieve these cost savings. Given the abuse of market power in the cable industry and the potential for abuse in broadband, the unique value of gaining AT&T as a local telephone competitor is doubtful at best.

subsidiaries. AT&T wants the federal authorities to accept these voluntary agreements as a substitute for true separation of ownership and independence of financial interests.

Policymakers should easily see through this diversion. In AT&T's theory, the company could own all the property in the industry and still pass regulatory muster, if it set up enough voluntary, artificial separations. That is a path that policymakers should decline to go down now, just as they did when AT&T proposed it as an alternative to breaking up the old end-to-end telephone monopoly. The independence is a charade. A recent column in USA Today, makes the point, citing, ironically, officials of Microsoft among others.

> Microsoft is debating whether to proceed. Chief Financial Officer Greg Maffei told analysts last week. Tracking stocks bring a mess of complications. They require extra accounting and effort to keep employees and investors from feeling slighted by the allocations of resources to sibling businesses.
>
> Says [Jeffrey] Haas [a tracking stock expert at New York Law School]: "the problem with this structure is that it lends itself to favoritism by executives and directors without recourse." Jeremy Stein, professor at Massachusetts Institute of Technology, notes tracking stocks have been described as "trust-me securities," companies are asking to be trusted not to take from the pockets of one set of shareholders and give to another whose business may be slipping.
>
> The temptation to violate the trust would increase in a recession, particularly because tracking stocks are at risk to debts of the entire corporation. Haas says trackers are "financial Siamese twins" who both suffer if one becomes ill…
>
> When hard times come, says lawyer John D'Alimonte of Willkie Farr, directors will squirm trying to deal with conflicting interests as share prices fall.[51]

Regulators do not have to rely on general concerns about "trust-me securities" to understand why they should see through this diversion. Liberty, the programming subsidiary

[51] Henry, David, "Creating 'Tracking Stocks' Could Backfire," *USA Today*, July 29, 1999.

that that is supposed to be independent within the holding company, has been spun off from TCI and pulled back so many times its corporate logo should be a yo-yo.

3. OVERLY BROAD MARKET DEFINITIONS

AT&T's third diversion is to the define market in overly broad and "potential" terms. This diverts attention from the highly concentrated actual markets that AT&T will dominate. For example, AT&T argues that narrowband and broadband Internet services are in one market, even though broadband has 1000 times the speed. This is like claiming that the pony express and Federal Express are comparable forms of mail delivery.

Similarly, AT&T wants federal authorities to assume that future performance of competing technologies will prevent the current abuse of market power. AT&T wants regulators to bet on a technological breakthrough or a miraculous market transformation in failed technologies. Those are the very same technologies that have failed to prevent the abuse of market power in the very recent past. Consumers have been waiting for an alternative technology to break the monopoly power of the cable industry since it was largely deregulated in 1984. We hope such a breakthrough will occur, but merger and market power analysis should not be based on hope or hype.

D. CONCLUSION

Just two years ago the Federal Trade Commission (FTC) looked at a merger between Time Warner/Turner/TCI that looked very similar to the one that has been proposed by AT&T, which involves TCI and MediaOne (which owns a substantial stake in Time

Warner/Turner).[52] The FTC rejected that merger and imposed conditions on it. It rejected a preferential deal for TCI purchase of Time Warner programming and required TCI to reduce its level of ownership in Time Warner to less than 10 percent of nonvoting stock (i.e. a non-attributable, passive level).

The FTC found that the programming market was concentrated.

> The sale of Cable Television Programming Services to MVPDs in the United States is highly concentrated. whether measured by the Herfindahl-Hirschman Index (commonly referred to as "HHI") or by two-firm and four firm concentration ratios.[53]

The same is true today of the market for the sale of Television Programming Services to MVPDs (we refer to this as the cable programming market). The same is true of the broadband cable market. Indeed. this market starts at much higher levels of concentration.

The FTC found that "entry into the relevant markets is difficult,, and would not be timely, likely or sufficient to prevent anticompetitive effects.[54]" With respect to the programming market it found

> Entry into the production of Cable Television Programming Services for sale to MVPDs that would have a significant impact and prevent the anticompetitive effects is difficult. It generally takes more than two years to develop a Cable Television Programming Service to a point where it has a substantial subscriber base and competes directly with the Time Warner Turner "marquee" or "crown jewel" service throughout the United States. Timely entry is made even more difficult and time consuming due to a shortage of available channel capacity.[55]

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[52] Federal Trade Commission, *In the Matter of Time Warner Inc., Turner Broadcasting Systems Inc., Telecommunications Inc. and Liberty Media Corporation,*, Complaint, Docket No. , September 1997 (hereafter, Time Warner/Turner/TCI).

[53] Time Warner/Turner/TCI, pp. 6-7.

[54] Time Warner/Turner/TCI, pp. 7.

[55] Time Warner/Turner/TCI, pp. 7.

Much the same is true of that market today.

Given the underlying conditions, the FTC found that the merger would unacceptably increase concentration in the programming market.

> The post acquisition HHI for the sale of Cable Television Programming Services to MVPDs in the United States measured on the basis of subscription revenues would increase by approximately 663 points, from 1,549 to 2,212 and will increase even further if Time Warner converts WTBS from a "superstation" to a cable network charging subscriber fees. Post acquisition, Time Warner will be the largest provider of Cable Television Programming Services to MVPDs in the United States and its market share will be in excess of 40 percent.[56]

The impact of the AT&T/MediaOne merger would be even larger, resulting in an even more highly concentrated market programming market and a leading firm with an equally large market share. The increase in concentration in the broadband programming market is even more dramatic than the cable market.

The FTC found that the distribution market is highly concentrated.

> The post-acquisition HHI for the sale of Cable Television Programming Service by MVPDs to households in each of the local areas in which Respondent Time Warner and Respondent TCI sell Cable Television is unchanged from the proposed acquisition and remains highly concentrated.[57]

The same is certainly true today of the market for the sale of Cable Television Programming services to households (we refer to this as distribution). In every local market there is a virtual monopoly a MVPD distribution. The same is true of broadband Internet distribution.

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[56] Time Warner/Turner/TCI, pp. 7.

[57] Time Warner/Turner/TCI, pp. 7.

The FTC found that entry into the distribution market is also difficult.

> Entry into the sale of Cable Television Programming Services to households in each of the local areas in which Respondent Time Warner and Respondent TCI operate as MVPDs is dependent upon access to a substantial majority of the high quality, "marquee" or "crown jewel" programming that MVPD subscribers deem important to their decision to subscribe and that such access is threatened by increasing concentration at the programming level, combined with vertical integration o such programming into the MVPD level.[58]

Little has changed in the cable markets identified by the FTC. Moreover, the severe vertical problems posed by the merger extend beyond cable TV services into broadband Internet services.

Because the cable operators are near monopolists in their local areas, traditional horizontal analysis does not find harm in mergers. The FTC concluded, we think incorrectly, that two monopolists are no better than one. However, the FTC did conclude that vertical aspects of the merger could harm competition in the distribution market.

> Respondent Time Warner and Respondent Turner are actual competitors with each other and with other sellers in the sale of Cable Television Programming Services to MVPDs and Time Warner's HBO, and Turner's CNN, TNT and WTBS ,are a large percentage of the limited number of "marquee" or "crown Jewel" Cable Television Programming Services which disproportionately attract subscribers to MVPDs.
>
> Respondent Time Warner faces actual and potential competition from other MVPDs and potential MVPD entrants in the sale of Cable Television Programming services to households in each of the local areas in which it serves as an MVPD.

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[58] Time Warner/Turner/TCI, pp. 7.

> The effects of the agreements, if consummated, may be substantially to lessen competition in the relevant lines of commerce in the relevant sections of the country in violation of Section 7 of the Clayton Act.[59]

The same is true of the broadband programming market. The two dominant firms in that market are joined by this merger and their domination would be even greater.

The enumeration of the ways in which the merger is a threat to lessen competition are instructive for both the cable TV and the broadband Internet markets. First with respect to programming the FTC saw a number of grounds for believing competition would be lessened.

> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs, directly or indirectly (e.g. by requiring the purchase of unwanted programming). Through its increased negotiating leverage with MVPDs, including through purchase of one or more "marquee" or "crown jewel" channels on purchase of other channels.
>
> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs by raising barriers to entry by new competitors or to repositioning by existing competitors, by preventing such rivals from achieving sufficient distribution to realize economies of scale; these effects are likely, because
>
> (1) Respondent time Warner has direct financial incentives as the post-acquisition owner of the Turner Cable Television Programming Services not to carry other Cable Television Programming Services that directly compete with Turner Cable Television Programming Services; and
> (2) Respondent TCI has diminished incentives and diminished ability to either carry or invest in Cable Television Programming Services that directly compete with the Turner Cable Television Programming Services because the PSA agreements require TCI to carry Turner's CNN, Headline News, TNT and WTBS for 20 years, and because TCI, as a significant shareholder of Time Warner, will have significant financial incentives to protect all of Time Warner's Cable Television Programming[60]

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[59] Time Warner/Turner/TCI, pp. 7-8.

[60] Time Warner/Turner/TCI, pp. 8.

The cable TV programming market has not changed since the FTC made these observations and the merger recreates these anticompetitive incentives and sources of market power. The impact of the merger on the broadband programming market is even more powerful. AT&T is using the cable-broadband wire as its "crown jewel." It conditions access to cable-based broadband transmission capacity on the taking of "unwanted programming." Consumers must buy the @Home service before they can have access to other services over the broadband pipe.

The FTC also concluded that the merger could reduce competition in distribution markets by

> denying rival MVPDs and any potential rival MVPDs of Respondent Time Warner competitive prices for Cable Television Programming Services, or charging rivals discriminatorily high prices for Cable Television Programming services. [61]

Little has changed in the vertically integrated, horizontally concentrated cable TV industry since the FTC reached those conclusions. The proposed merger places even more market power in the hands of AT&T. On the broadband side, price and quality discrimination are at the core of the @Home business model.

Thus, in both the traditional cable services and evolving broadband Internet services, at both the federal and local levels, the effort by a large, dominant firm to gain a commanding economic position on the information superhighway through merger and other forms of vertical domination have encountered resistance. The stiff resistance arises because the

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[61] Time Warner/Turner/TCI, pp. 8.

merger breaks recently enacted and clear rules regarding ownership and franchise authority under the Communications Act, as well as the merger guidelines adopted under the Sherman and Clayton Acts.

Although the FTC allowed the Time Warner/Turner/TCI merger to go forward with conditions, the AT&T/MediaOne merger poses a much more serious threat to consumers. The industry has become more highly concentrated and the broad picture of combined horizontal and vertical concentration/integration should spark greater concern. Given the web of cross ownership, joint ventures, and exclusive or preferential deals, the likelihood that any of the companies identified in Exhibit 2 will vigorously compete against the other companies in the cartel is slim.